

AN INTERNATIONAL EQUALIZATION PROGRAM (IEP): RATIONALES, ISSUES, AND OPTIONS

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ABSTRACT

The paper raises and discusses issues related to the potential benefits, institutional arrangements, and design of an international equalization program in support of existing forms of international aid to developing nations. The structure and nature of existing equalization and equalization programs are discussed and their rationales are extended from a domestic to an international context. Some options for an IEP, including, scope, conditionality, funding among recipient nations and financing among donor nations are discussed. The paper concludes that much additional political and analytic work is required before such a program could be introduced, and that one or a series of international conferences would be an appropriate forum to explore the issues. These conferences could culminate in a pilot project that would form the basis for assessing the key aspects for a wider program.

1.0 INTRODUCTION

1.1 Motivation and Purpose

The motivation for this paper derives from several perspectives. On the one hand, despite extensive development efforts over recent decades, progress has been less than stellar for many developing countries. Much aid is directed at specific projects in specific regions but there do not appear to be any systematic international development financing programs for improving the extent and quality of basic public services throughout a country.

By contrast, when one looks at developed nations, the provision of a high level of basic public services at reasonably comparable levels across the country is more or less taken for granted. Formal general purpose fiscal transfer programs among levels of government within a nation that are directed to this purpose are

generally referred to as “equalization” programs. In addition, many specific-purpose transfer programs between levels of government often incorporate equalizing elements.

While the availability of public services in these developed countries has progressed over time in line with economic development, it is recognized, as well, that the relationship between a high level of public services and social and economic development is symbiotic. In particular, a high level of basic public services, such as health and education, provides significant support - and, indeed, may be essential - for enhancing social and economic development.

Thus, there appears to be a serious inconsistency between what developed nations prescribe and undertake for their own populations and what they focus on in supporting social and economic development for the populations of developing nations.

There is another important dimension to this issue. Within many nations, particularly within federations with significant disparities in income levels among jurisdictions, the goal of redistribution to enable improved public services by sub-national jurisdictions in poorer regions is generally accepted as a concomitant of nationhood and social cohesion. With the rapidly expanding trends toward globalization and the expanding perspective of the world as a “global village”, is it now politically feasible to extend this national perspective on sharing for equitable access to public services into the international context?

What would be involved in removing this lack of consistency between the nature of developed governments’ support for their own population and for the population of developing countries - in extending the concepts, principles, and financing arrangements for equalization programs from an intra-national to an international context? The purpose of this paper is to examine rationales for, and issues related to, establishing such an International Equalization Program (IEP). What would be

involved in establishing formal international redistributive fiscal arrangements of this nature? Some of the issues and options related to the design and administration of an IEP are also examined in this paper.

Could an IEP contribute to widely and equitably available public services and, thus, enhanced opportunities for social and economic development economic within developing countries? Alternatively, it may be asked whether there are reasonable prospects for social and economic development in many developing countries, in the absence of some broadly-based enhancement in basic public services and if not, whether a formal international equalization program should be considered as a significant component of international development efforts.

1.2 Outline of the Paper

This paper is structured as follows. Section 2 presents a brief overview of the nature of equalization programs, followed by some examples of equalization programs in a number of federations and unitary states. This is followed by a review of the major rationales of a social, economic, and political nature that have been offered for equalization programs. Some arguments against equalization programs are also presented.

Section 3 focuses on extending the rationales for equalization within nations to an international context based on political, social, and economic considerations. The relationship between equalization programs and traditional forms of aid and how they might interface and be mutually supportive is discussed. The section concludes with arguments against an international equalization program and the major barriers to creation of such a program.

Section 4 sets out a range of options for the magnitude and structure of an International Equalization Program. A discussion is then presented of the types of general and specific conditions that might be necessary for the acceptance and success of a program. This is followed by an examination of some options for governance and administrative arrangements,

including measures for monitoring activity, accountability, and sanctions.

In Section 5, some considerations for the analytical design of an IEP are presented, for both the funding of recipient nations and the financing from donor nations.

Section 6 concludes the paper by outlining possible future work of a political and analytical nature and proposing a pilot project to test the feasibility and desirability of an IEP.

2.0 EQUALIZATION IN A NATIONAL CONTEXT

2.1 Characteristics of Equalization Programs

Equalization programs are designed to “level the playing field” among governments (or other bodies providing similar services) at a given level in order to enable them to provide reasonably comparable levels of services to their residents at reasonably comparable tax burdens. Alternatively, formally, the purpose of an equalization program is to provide “horizontal” fiscal equity among residents of different jurisdictions. It is most important to recognize that equalization programs are directed toward greater equity in access to public goods and services provided by governments and not income disparities among populations in different jurisdictions. Another way to describe an equalization program is that it is designed to fill the “fiscal gap” between a measure of a government’s “expenditure needs” and a measure of its “revenue means”.¹

There are a number of key principles and desirable characteristics that are generally chosen to underlie the design of equalization programs. However, as will be illustrated in the following section, there are wide variations in

¹ This characterization of an equalization program may include both transfers designed to reduce horizontal imbalances among governments, as those that address as a “vertical” fiscal imbalance between the measurement of revenue means may include revenues from certain other designated transfer programs.

how equalization programs are designed and administered around the world.

The key principles selected are generally:

- Equity, as the key rationale and objective
- Economic efficiency in the allocation of resources

Other desirable characteristics may include:

- Sensitivity/responsiveness to differences among jurisdictions and changing circumstances over time
- Stability
- Predictability
- Timeliness
- Robustness
- Sustainability
- Risk Sharing
- Objectivity
- Administrative Efficiency
- Clear Responsibility and Accountability
- Transparency
- Effective Mechanisms for Dispute Resolution
- Effective Mechanisms for Review

A key element of the design of an equalization program is the expenditure standard chosen and how it is measured. The structure of the expenditure standard can vary from a simple aggregate equal per capita measure to a composite of sectoral, or possibly sub-sectoral, measures based on client groups, with adjustments for specific needs and costs factors. Generally, the sectors covered include all those for which the (recipient) jurisdictions have full or partial financing responsibility.

The equalization level or standard can vary from some minimum level to an average of some jurisdictions, an average of all jurisdictions, or a very high standard based on the highest jurisdiction. The standard could be set at 100% or some percentage, say 90% or 95% of these measures.

There are a number of important dimensions on the revenue side, as well. Coverage of

revenue sources can be complete or some sources could be excluded for any of a number of valid reasons, specific to the context. Generally, what is taken into account is a measure of revenue “capacity” rather than actual revenue, in order to provide for greater comparability, as well as to reduce the influence of a jurisdiction’s revenue policies on the level of its transfer. Revenue capacity may be measured in a wide variety of ways, ranging from a single aggregate measure based on GDP to an aggregate of capacities of specific revenue sources, each based on a uniform measure of a tax base to which a single tax rate, or a composite of tax rates, is applied. The tax rates employed may be based on an average of all jurisdictions or some other measure. All revenue capacity may be included at 100% or some percentage(s) less than 100% may be applied to some or all revenue sources, in order to provide for a “fiscal incentive”.

Depending on the range of expenditure responsibilities taken into account, revenue means may include both own source revenues and certain specific-purpose transfers targeted at some of the expenditures included in the expenditure base, in order to avoid double-counting.

The derived fiscal gaps between the designated measures of expenditure need and revenue means may be fully funded or only partially funded. In some cases, the measured gaps are fully funded, subject to an upper aggregate funding limit. In others, the budget might be preset through an independent process. Where funding is constrained, there are alternative approaches applied to paring back allocations.

The financing of equalization transfers may take a number of forms.. It might be financed exclusively by the more senior level of government from its own revenues, a so-called “gross” program, or it might be fully financed through redistribution of revenues among the sub-national governments subject to equalization, a so-called “net” program. Combinations of gross and net

financing are also possible. Financing might take the form of cash transfers or tax sharing arrangements or some combination of the two.

The currency or timeliness of data used to determine entitlements may also vary in a number of ways. Lagged data for recent year(s), moving averages of several recent years, and/or current year data might be used for measuring expenditure needs and/or revenue capacity. Where the outcomes are not fully known within the fiscal year for which funding is provided, processes must be put in place for adjustments to payments over time.

The measures of expenditure need may be carried forward over time in a number of ways. Escalators may be used or the formulas may be applied each year. Regardless, it is essential to revisit the formulas and the measures of both expenditure need and revenue means periodically to reflect changing circumstances, and to respond to emerging problems and changing priorities. Various institutional arrangements and processes, some formal and routine and some ad hoc, are generally established for reviews.

Equalization grants may vary in degree of conditionality. Where sub-national governments have significant jurisdictional powers over the programs they administer or deliver, equalization grants tend to be unconditional. The greater the extent to which programs delivered by sub-national governments are based on delegation of authority from a more senior level of government, the greater is the extent to which conditionality is likely to be applied. However, conditions might not be attached to the equalization grants per se, but specified through the delegation arrangements.

Equalization programs may be designed and administered in several ways. In some countries, the task for establishing the formulas for expenditure need and revenue capacity are given to independent bodies. In some case, these bodies advise only on allocation matters, in others they may advise on the overall level of funding, as well. In other countries, matters are

left to a donor government minister and his/her departments to both establish, maintain, and operate the arrangement, usually in consultation with receiving governments and possibly experts. Legislatures may play varying roles, ranging from passive, reactive, advisory, close oversight, to a high degree of constitutional responsibility.

2.2 Some Examples of Equalization and Equalization-Type Programs

The above section has provided an overview of the range of matters involved in designing and managing an equalization program. In this section, some examples of equalization programs in operation are briefly described.

Perhaps the oldest formal equalization program still in operation today is the one in Australia that began in 1933. The Commonwealth Grants Commission (CGC) is an independent body with the mandate to recommend the funding formula and determine the “relativities” for each of the states and territories. To that end, over time, the CGC, supported by research staff, has developed very extensive and complex measures of expenditure need on a sectoral basis, that take into account a range of need and cost factors. The equalization standard is based on the needs and costs-adjusted average of all states.

The GWC holds public hearings and takes briefs from the state governments, the Commonwealth government, experts, interest groups, and members of the public at large.

After much dispute and a number of efforts to find a way to achieve greater agreement between the Commonwealth and state governments on the aggregate level of funding, it was agreed that, following a transition period, the level of funding will become equal to the proceeds of the national value added tax.

It is important to note that the major part of the “General Revenue Grants” from the Commonwealth to the state governments addresses the “vertical” fiscal gap between the two levels of government, as opposed to the

“horizontal” imbalances among the states and territories. This is because most of the revenues accrue to the Commonwealth government while many of the expenditure programs are delivered by the state governments.

Germany also operates an equalization program to support the fiscally weaker Länder or states. The program began in 1951 and was initially given a constitutional basis in 1955. The program is designed and administered by the federal government but the Bundesrat, the second house that represents the Länder in the national legislature, plays a very important role in maintaining a balance between the federal and state governments’ fiscal interests. The measures of expenditure requirements are basically equal per capita, with some minor adjustments, mainly based on the degree of urbanization and population density. The minimum standard is 95% of the post-equalization average per capita.

While the formula is less elaborate than in Australia, the financing of the transfers are more complex, with funding from three sources: (i) a portion of the VAT shared with the states, (ii) a unique scheme of interstate equalization, which is progressive in structure, and (iii) a variety of vertical grants from the federal government that favour certain Länder.

In Canada, there were elements of equalization in the “Tax Rental” agreements between the federal government and the provinces introduced during the Second World War, but a formal equalization program to address inter-provincial fiscal disparities was only introduced in 1957, based on only three revenue sources. In 1967, the so-called “Representative Tax System” (RTS), covering a wide range of provincial government revenue sources was introduced. The funding formula is based only on equalization of revenue capacity per capita, with differences in expenditure needs (that may exist) not taken into account.

In 1982, revenue coverage was expanded to include most local government revenue sources. Also, in 1982, the program was given a constitutional basis under Section 36(2) of the

Constitution Act, 1982, the only federal government program to have that status.

Beginning in 1982, in order to reduce the cost of the program and instability arising from fluctuations in oil and gas prices, the standard was changed from a national average to a “Representative Five Province Standard”, that excludes Alberta at the high end and the four Atlantic provinces with the lowest fiscal capacity. Also, in 1982, a ceiling was instituted, based on the cumulative rate of growth of Gross National Product, that is rebased with each renewal. Recently, the Prime Minister agreed to remove the ceiling.

The program is based on legislation that sunsets (generally) every five years and, thus, there is a review process leading up to each renewal. The program is the responsibility of the federal Minister of Finance and is fully funded by and administered by his/her department. The renewal process generally involves consultations among the federal and provincial departments of finance at several levels - technical working groups, senior officials, deputy ministers and ministers. Although the program has a legislative base, it is basically determined primarily by the federal Minister of Finance.

While the formula is determined by the federal government, most of the data on which the calculations are based are certified by the Chief Statistician of Canada, thus removing much potential conflict on the data used to determine entitlements.

In comparison with the Australian equalization program that uses lagged data, the Canadian equalization program has traditionally been based on actual revenues and population for the year in question. Thus, final estimates of entitlements are only determined with a delay of several years. As a result of forecasting errors and adjustments to payments for several fiscal years at the same time, unexpected outcomes often create instabilities in provincial government revenues.

Equalization payments are financed entirely

by cash transfers from the federal government. Payments are unconditional.

Because expenditure needs and cost differences are not taken into account in the program, as in Australia, the equalization program for the provinces would not provide adequate fiscal support to the northern territorial governments if applied to them. Beginning in 1985, Territorial Formula Financing (TFF) was introduced to provide formula-based unconditional equalization-type transfers from the federal government to the Yukon and the Northwest Territories (which was subsequently divided into two territories in 1999, Nunavut to the east and the Northwest Territories to the west).

Expenditure need is not taken into account in an explicit way, but the "Gross Expenditure Bases" (GEBs) per capita are several times the level of the equalization per capita revenue standard for the provinces, reflecting the higher costs and higher needs of the population, including many aboriginal peoples, in the territories. Revenue capacity is based on the RTS of the equalization program applied in a modified way.

Since its introduction in 1985-86, TFF has been based on written agreements between federal and territorial ministers of finance. The agreements have generally had five-year livetimes and TFF has also been subject to review leading up to renewal. In 1995, administration of the program was transferred from the Department of Indian Affairs and Northern Development to the Department of Finance.

While discussed from time to time, the program does not have a legislative basis, as does the Equalization program. It also does not have a constitutional basis but there appears to be general agreement, in principle at least, that the equalization principle of Section 36(2) should apply to funding under TFF. Nevertheless, after the repeated application of a ceiling and an ad hoc downward adjustment to the GEBs over the last decade or so, there is much dispute by the territorial governments

concerning the adequacy

of the levels of the transfer, in terms of enabling reasonably comparable levels of public services in the north.

Switzerland's equalization program for the cantons was first legislated in 1959. The program has some similarities with the one in Germany, with limited adjustments for expenditure need based on population density and rurality, and a three-part financing structure.

The reformed states of South Africa and the Russian Federation also have instituted equalization programs for their provinces or regions. In South Africa, there is a constitutionally-based Financial and Fiscal Commission that advises on both the allocation and the level of transfers to the provinces. The Russian equalization program is based on fairly extensive measures of expenditure need, although the data used need to be improved in both quality and timeliness. The allocation formula, negotiated by regional representatives, has a rather unique two-tier structure. The annual level of funding for the program, financed by the central government, is determined independently of the funding formula.

India has had Finance Commissions for over 50 years that advise on both the aggregate level and allocation of fiscal grants to the states. While the grants commission in Australia is a permanently operating institution, the commissions in India are reconstituted for each fiscal review.

Unitary states often operate equalization programs for their local governments. For example, the United Kingdom (and now Scotland and Wales, as well), Denmark, and Japan operate formula-based equalization transfers to their local governments toward enabling comparable service levels across the country.

Governments also operate sector-specific

equalization-type programs for their sub-national government units. For example, in Canada, most

provincial governments fund transfers to local school boards that take into account expenditure need factors and revenue capacity associated with the education portion of the property tax.

2.3 Rationales

The rationales for equalization derive from several perspectives that are somewhat intertwined.

2.3.1 Social

A federal system of governments allows for potentially greater responsiveness in the supply of public services to differences in demands of the population among jurisdictions. In that sense, it enables greater economic efficiency in public program and service delivery. But that benefit may come at a price. In particular, where there are significant differences in the fiscal capacities of sub-national governments to provide reasonably comparable levels of public services, the full extent of the potential benefits may not be realizable. Equalization programs are designed to create that greater equality of access, so that the benefits of decentralization of government can be more fully achieved.

The call for equalization is based on the desire for equity and social cohesion - that all people across the country should be treated reasonably comparably by government, no matter where they live. This general objective is expressed in several different ways as the principle underlying national equalization programs.

In Canada, it is stated, under Section 36(2) of the *Constitution Act, 1982*, as:

“36(2) Parliament and the government of Canada are committed to the principle of making equalization payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.”

In Australia, the objective is stated, similarly, as:

“Each State is entitled to receive a level of general revenue funding from the Commonwealth which would enable it to provide, without having to impose taxes and charges at levels appreciably higher than the levels imposed by the other States, government services at standards that are not appreciably different from the standards provided by other States.”

The objective in Germany is stated as “Equality of living standards”, although the program is directed to equalizing only for public services and, even within public services, differences in expenditure need are taken into account in a limited manner.

2.3.2 Economic

The economic argument in support of equalization derives from both equity and efficiency perspectives.

With regard to equity, the argument is based on the principle of horizontal equity - that persons in essentially similar circumstances before interactions with government should remain in comparable circumstances after interactions with government. To the extent that sub-national governments have differences in fiscal capacities to provide public services, the same level of public services to two similarly-placed individuals in different jurisdictions would require differences in tax rates, thus violating the principle. Equalization transfers, by enabling these differences to be significantly reduced or eliminated, allow the principle to be achieved, at least in theory, if not in practice. In this regard, it is important to note that the objectives of equalization programs are generally stated as to enable comparability of treatment to be achieved, rather than to guarantee it. To the extent that sub-national governments have jurisdictional powers over the public services that they provide and the taxes that they levy, and can differentiate them from

those of other governments to meet the particular needs, preferences and priorities of their constituents (which is the rationale for decentralization), then

actual equality of treatment of similarly situated individuals may, in fact, not be realized. The economic term “fiscal equity” is, therefore, generally used to refer to the objective, rather than the outcome, of equalization programs.

Boadway and Flatters (1982) have argued that equalization can also contribute to economic efficiency, a rare circumstance, since it is generally the case that the pursuit of equity is at the expense of economic efficiency and *visa versa*. The argument is that without equalization, people and capital will tend to migrate to fiscally better-off jurisdictions merely to benefit from lower tax rates and/or better public services, rather than for reasons of improved employment and income prospects. Such “fiscally induced” migration would detract from the economically efficient allocation of resources in the nation.

This argument is counter to the oft-heard view that transfers to low income regions interfere with the efficient allocation of resources. While this may be the case for certain types of transfer programs, it may not be so for equalization programs designed to address horizontal fiscal disparities.

Another possible economic argument in favour of equalization is that it can help to prevent economically distorting policies by sub-national governments to attract economic development. This applies to both governments of poorer jurisdictions that might see such instruments as the only way to overcome their handicap, as well as to governments of higher income states that may believe that they need not fear effective retaliation from lower income jurisdictions. (See the political argument by Breton (1985) in the next section.)

A somewhat broader, longer term, perspective on the argument for equalization in support of economic efficiency is that it enables

residents in poorer jurisdictions to benefit from a higher quality of education and health services, thus enhancing the development of the nation’s human resources over the shorter and longer term.

2.3.3 *Political*

Political arguments in support of equalization are made from several perspectives. One argument is that sharing is fundamental to nationhood. From a slightly different perspective, it is argued that reasonably comparable access to services at reasonably comparable tax rates is a fundamental right of citizenship. Some would argue, similarly, that political cohesiveness and continued support of the nation requires such reasonable comparability to be maintained.

A rather different political argument in support of equalization is made by Breton (1985). In the framework of a competitive model of federalism, where sub-national governments are seen to be competing amongst themselves for population and economic activity, it is essential that they be able to do so on a “level playing field”. Equalization is a mechanism that enables that fair competition to ensue.

2.4 **Some Arguments Against Equalization**

There are a number of arguments that have been mounted against an equalization program. Based on the simplistic Tiebout model - with zero transaction costs for moving and jobs available everywhere - it has been argued that equalization would be achieved without intervention, by having people “vote with their feet”. However, in the real world, a recent study by Day and Winer (2001) found that moving costs were a very significant impediment to migration in Canada.

Another argument that has been made is that horizontal fiscal disparities will be eliminated by capitalization in land values so that the incentive to migrate for fiscal benefits will be eliminated. It has also been argued that equalization results in a psychology of greater dependency among both the population and governments receiving transfers, and can create an equivalent of the

“welfare trap” for receiving governments. Lastly, at the broadest level, some would argue against the objective of fiscal equity in principle, that it should not be addressed by government policy—that it should be left to the market to resolve.

In fact, the United States, likely as a result of some combination of the above arguments, is the only developed federation that does not have a formal equalization program. Some have suggested, in jest, that equalization is carried out in the country through defense expenditures. The federal government does offer a wide range of specific-purpose transfers to the state governments, some with equalization elements and some without. Even though they may not be equalizing on the expenditure side, they may be equalizing on the financing side, to the extent that federal government revenues are financed in a progressive manner among the states. (The author is not aware of any analysis on the extent to which the aggregate of these programs is equalizing.) While there are income disparities among the population of the states, they are no greater than those that exist amongst sub-national jurisdictions in developed countries with equalization programs. The high degree of internal mobility in the United States likely contributes to reducing fiscal disparities, somewhat along the lines of the Tiebout model. Additionally, compared to Canada and Australia, for example, natural resource revenues in the United States accrue to the federal government, while they are primarily received by provincial or state governments in the other two countries.

2.5 Summary

In summary, one perspective on many of the arguments for or against an equalization program within a nation is that they are closely related to the question of “convergence” - whether or not the natural social and economic forces toward regional economic convergence outweigh those toward increasing spatial disparities, what factors and policies contribute to or inhibit convergence, and if convergence is the dominant trend, the likely time frame involved.

3.0 EQUALIZATION IN AN INTERNATIONAL CONTEXT

The paper now moves beyond the traditional framework for equalization, both in theory and practice, into expanded territory.

This section extends, where possible, the traditional arguments for equalization from a national context to an international one. A comparison of equalization to traditional forms of aid is then presented and the potential contributions of the equalization approach are outlined.

There are a numerous arguments that could be made against international equalization and many barriers that would prevent its introduction. Rather than turning away from these realities, they are identified in a forthright manner. The following sections also attempt to address some of these concerns in greater depth.

3.1 Rationales

As in the case of equalization within a nation, the rationales for an IEP can be made from the political, social, and economic perspectives.

3.1.1 Political

At the broadest level, an IEP would signal a recognition of the “Global Village”, that the well-being and fate of people everywhere are integrally intertwined. It would be a message from people and their governments in the wealthier countries that they are intensely concerned about the political, social, and economic development prospects of the residents of lesser developed nations. The operation of an IEP could also foster greater awareness and understanding, amongst governments and people of developed nations, of conditions within the lesser developed nations.

Within recipients nations, equalization could support greater democratization and improved governance in several ways. First, as will be discussed in Section 4.2, international

equalization to poorer countries would likely have conditions attached, some related to democratic and good governance. Secondly, government legitimacy, particularly of national governments, through which equalization payments would flow, would likely be strengthened, since they would be in a stronger fiscal position to provide public programs and services of benefit to people, particularly, the poorer segments of the population, either directly or through funding to sub-national governments for that purpose. Since funds would need to be distributed in a way that would reduce gaps in the access to public goods and services provided by both the national and sub-national governments, there could be greater prospects for political cohesion within the nation.

3.1.2 *Social*

An IEP could contribute to a reduction of social disparities both within the lesser developed nations and between them and more developed nations, in a systematic fashion. It could, thus, contribute to greater social cohesion both within countries and throughout the world. It will take both aid and balanced trade to improve the social and economic circumstances of the many people in need within the foreseeable future. It will be argued in Sections 3.2 and 3.3, that international equalization can be a most effective form of aid, partly in replacement of, and partly complementary to, existing aid programs, and can contribute in a number of ways to expanded trade.

3.1.3 *Economic*

The benefits of equalization will reverberate through the economies of recipient countries, in both the short and longer run, through a variety of mechanisms. To the extent that additional funds flow to governments to provide public goods and services, there will be an increase in the level of economic activity in the receiving countries. Poorer regions should benefit to a relatively greater extent than the better-off regions, given the nature of equalization. There would be more employment opportunities for certain professionals within the recipient countries, such as for doctors, other medical

professionals, and educators, thus reducing the loss of limited highly qualified human resources through out-migration to wealthier countries. To the extent that equalization transfers provide support to health services, the benefits in health outcomes should be reflected in improved labour productivity. Expanded and improved education will also enhance the quality of labour in the

future. The improved availability of public services in poorer regions could reduce migration to over-crowded large urban regions.

There would be benefits for donor countries as well. Some of the funding would find its way, through imports, to donor countries, so that the net cost would be less than the initial transfers. Secondly, from a strategic perspective, many developing countries may be reluctant to engage in a freer trade arrangement with developed nations, even if traditional trade barriers are much reduced, unless there is additional support of aid to ensure that the benefits of trade are equitably shared and that, over time, trade can occur on a more level playing field, particularly in terms of the quality of human resources. The question would then be what form(s) that aid should take. The role of equalization within the various forms of aid is discussed in the next section.

3.2 Equalization and Traditional Forms of Aid

Currently, aid to developing nations takes many forms including: macro-economic policy advice; advice on reform of public administration and fiscal management, capacity-building, legislative and regulation; advice and financial support for economic development; advice and financial support for enhancing the public infrastructure and the provision of public services; sectoral, project, group, and/or location-specific financial support; and direct participation. The list is almost endless. Donors include a range of international organizations, foreign governments, non-governmental organizations, and an endless cadre of consultants acting on their behalf.

In many cases, governments of recipient countries are bystanders to these efforts, the direct benefits to people in need are elusive, and there is much duplication and lack of coordination of effort. Advice, in the form of a stream of reports - though often sound - is not acted upon. Sometimes, as argued from time to time, by well-informed experts - for example,

recently by Stiglitz (2002) - fundamental advice, that has been forced upon or voluntarily acted upon, has been extremely damaging to entire national economies and has impacted significantly negatively on the most desperate and vulnerable groups in society.

It is not the purpose of this paper to assess international development efforts but, as indicated in the introduction, it appears to the author that there is a gaping hole in the matrix of development programs. As argued in Section 2.2, the form of support that most developed nations provide and take for granted internally, namely systematic fiscal support to ensure that basic public services of reasonable quality are widely available to the appropriate population groups throughout the nation - through equalization and equalization-type programs, is missing from the varied package of international aid programs.

As noted above, there is often duplication and lack of coordination amongst development efforts of different donors. An equalization program for basic public services could provide a unifying framework within which relevant aid programs could be encompassed, providing for greater coordination and reduced duplication. Moreover, equalization funding need not all be incremental. It could substitute for many components of aid currently provided to support the provision of public services in one form or another.

Since the funds would flow directly to recipient national governments in the first instance, it would be those government that would be involved in determining the form and allocation of support, subject to any conditions

that would apply. Specific aid measures in the area of public services would be directed to, and delivered within, the overall structure of governmental priorities. Moreover, as is often advocated in the public expenditure management literature (see, for example, The World Bank (1998)), the funds would flow through, and be accounted for within, the unified budgetary and fiscal framework of the governments of recipient nations.

Moreover, as the administration cost component of equalization programs is comparatively low, most of the expenditure would find their way directly to people in need through programs and services. Additionally, as their purposes are generally relatively simple and straight-forward, it is generally more feasible to evaluate these expenditures in terms of outcomes.

In that respect, it is interesting to consider the experience of the European Union with its Structural Funds. In the 1970s, the European Commission had a study undertaken to examine an equalization program for the Community. The Community rejected an equalization program and instead, the major instruments adopted to reduce regional disparities was the "Structural Funds" program. Currently, the Structural Funds consist of a number of sub-funds designed to meet three major objectives. For each objective, there are different sets of regions eligible. The nature of projects funded have been many and varied.

Sometime in the early 1990s, the Commission began to introduce formal evaluation processes for the Structural Funds, and many studies have been undertaken, The evaluation process has become an industry in itself. In June of 2003, the Commission held its fifth conference on the evaluation of the structural funds. A review of the program shows sessions on a wide range of topics related to evaluation, including appropriate methodologies and good practice for both program and policy evaluation, on methods and tools for impact evaluation, on capacity building for evaluation, on standards for and ethical issues in evaluation,

on learning from evaluation, and evaluation, accountability, and performance - virtually every aspect of evaluation except the actual evaluation of outcomes, themselves.

The methodologies for evaluation have become increasingly complex. The studies that have been undertaken and the results obtained are often a product of the assumptions made as much as the nature of the projects or programs being evaluated. Results are often inconclusive. Are Structural Funds cost-effective? If so, which ones? Toward which objective(s)? What are key criteria for success? Probably no one knows the answers to these and similar fundamental questions. In the view of the author, the Structural Funds, their objectives, and the projects funded are so complex as to probably defy systematic and meaningful evaluation, at least for the foreseeable future.

By comparison, it is much easier to count the number of children enrolled in school, or the number of people who have been vaccinated, or the number of people who have been treated for and cured of certain prevalent diseases, than it is to determine the nature and magnitude, and even the sign, of the net benefits arising from structural-type funding, of the type supported by the European Union.

3.3 Equalization, Trade and Migration

As suggested in Section 3.1, an IEP could play an important role both in the support for expanded trade as well as in enhancing the nature and extent of trading relationships over time.

The support could derive from both demand and supply side forces. On the demand side, some of the funding would flow back to the donor countries through increased imports of goods and services arising from the increased expenditures in recipient countries. The supply side effects, while taking time to evolve, are potentially more significant. By increasing the quality of labour through improved education and health services, and the overall quality of public services in support of economic activity, the productive capacity of the recipient countries

will be enhanced. This will both increase demands for personal consumption and business goods and services, as well as strengthening the export capacity of the donor countries.

While there are likely to be aggregate benefits arising from freer trade, there is no guarantee as to their distribution amongst participating countries. Thus, there may be the fear and, perhaps, the possibility, that the developing nations could become locked, for a long time, into existing structures of comparative advantage in trading relations with the highly developed economies, with high value-added and technically superior activities located in the latter nations, and low value-added, relatively low technology, production activities falling to the former. This need not be the case, of course, as exhibited by such examples as Japan, South Korea, and the emerging economy of China.

Additionally, transitions to changing trading relationships are not instantaneous and frictionless - there are potentially large and lengthy costs of adjustment. Disparities are likely to be exacerbated, both among regions and between people within regions, as some are better situated to benefit from the new economic arrangements. These disparities can be large and enduring. Even if there are aggregate benefits that result, the developing nations may not have the fiscal resources to address these potentially widening disparities that, if not ameliorated, could result in political and social destabilization, and possibly a generation or more of people socially and economically excluded from the mainstream economy and society.

Thus, developing nations may demand additional support measures to help ensure that they will share in the benefits of trade in both the short and long run, that costs of adjustment can be adequately addressed, and that the benefits can be equitably distributed amongst their population. An equalization program could form a major component of support programs to address these concerns.

As suggested above, another potentially important benefit for developing nations is that an equalization program could provide greater employment opportunities for scarce skilled professionals involved in the provision of public services. Such skilled labour, although scarce, might be under-employed because of lack of public funding, so that the full benefits of their services are not available to the population. As a result of lack of opportunities, such skilled workers are frequently lost to these countries through migration to wealthier nations. Losing such skilled labour is doubly costly to developing nations; first, because the public funds that have been invested in their education will not yield returns to their society, and secondly, because such badly needed skills are generally in short supply and require time and significant costs to replace.

3.4 Arguments Against and Barriers

The arguments against an IEP are likely to be many and varied. For example, they could include the following:

- The cost would be too great.
- The U.S. would be called upon to be a major contributor, yet does not even have an internal equalization program.
- A donor country would not be able to target its support or to exclude countries from benefiting from its financial contribution.
- It is not the responsibility of wealthier countries to ensure the availability of public services in the poorer countries.
- Expanded trading relationships do not provide a political framework to justify or to support that type of redistribution.
- Most developing countries will welcome free trade without that type of support.
- Free trade and existing aid programs will be sufficient to foster economic development in lesser developed countries. Equalization transfers would be redundant and unnecessary.
- There is no international political accountability framework. The funds would be wasted and the potential for corruption would be great. Much of the funds could end up being spent on military equipment, rather

than basic public services for the population. There are no feasible sanctions for misuse, other than non-provision in the future.

- It would lead to fiscal dependence of governments and people that could inhibit economic adjustment.
- It would be most difficult to assess the effectiveness of the use of the funds.

The last point was briefly discussed in the previous section. Some of these other arguments will be addressed in the following sections.

4. SOME OPTIONS

This section examines some options for certain key aspects of an IEP, including scope, conditionality, governance and accountability.

4.1 Scope

The term scope, in this context, refers to the range of sectors of public services covered by an equalization program. There are two general categories, broad and sectoral, and each is discussed in turn.

4.1.1 Broad Coverage

Under broad coverage, equalization would cover a broad range of public services, such as education, health, income support and social services, public housing, transportation, etc. This type of program would be modeled on the types of programs reviewed in Section 2.2, where funding is provided to cover virtually the full range of expenditure responsibility of the sub-national governments that are subject to equalization.

From the perspective of the objective of fiscal equity amongst constituents of sub-national governments, an equalization program should aim to be as broad as possible. Such broad-based transfers are usually referred to as “general-purpose” grants.

4.1.2 Sectoral Coverage

Under sectoral coverage, equalization would be based on expenditure needs in one or more selected sectors. Sectoral coverage could also include sub-sectoral coverage, for example,

primary and secondary education, but not necessarily post-secondary education. Targeted grants are generally referred to as “specific-purpose” grants.

Since most revenues raised are generally not earmarked for specific purposes, it would be necessary to infer or deem a certain portion of revenue capacity to be associated with the financing of public services in these sectors.

4.2 Conditionality

As noted earlier in the national context, the greater the jurisdictional powers of the sub-national governments, the lesser the degree of conditionality is likely to be. Moreover, the greater the range of expenditure responsibilities covered, the more difficult is it likely to be to enforce sector-specific conditions through expenditures. Other powers of the transferring government could be more effective in enforcing conditions.

Recipient nations may protest that any conditions would compromise their sovereignty. However, it is precisely because of their sovereignty and the limited possibilities for sanctions, except withholding future payments, that donor nations would likely want to apply conditionality to funding, in order to be able to provide a greater degree of assurance that the funds are being used for the purposes and in the manner intended.

Recipient nations may also argue that conditions are discriminatory, since they would only apply to recipient nations and not others. While this, too, has some validity, in reality, given funding constraints, it is likely that the conditions and standards required would be lower than those that are met in non-recipient countries.

Conditions can take a number of forms. They may be general in scope - not pertaining specifically to the programs and services for which the funding is provided, or specific in nature, where they are focused on the supported services.

4.2.1 General Conditions

It is likely that the majority of, if not all, donor governments would want certain types of general conditions to apply to recipient nations. General conditions applying to governments receiving equalization, of either the broad-based or sectoral-specific variety, might include some of the following matters:

- Democratic governance
- Equitable allocation
- Laws and penalties related to conflict of interest and misuse of funds by legislators and government officials
- Financial management controls
- Reporting on expenditures and outcomes
- In the case of broad-based equalization, a condition applying to the maximum level of defense expenditures may be sought.

4.2.2 Specific Conditions

Specific conditions would vary depending on the sector or sub-sector in question.

Specific conditions can often be expressed as, and based on, accepted standards. Specific conditions may apply to inputs or outputs. Input conditions, as the name implies, apply to input items, and could, for example, apply to levels of expenditures either, in aggregate, for specific services, or specific input factors, or they could apply to quality characteristics of input factors. Conditions related to client groups, for example, in the form of eligibility, can also be a form of input conditions. Input ratios, such as student/teacher or doctor/patient, are also forms of input conditions that can take the form of standards.

Output conditions can also take a number of forms and be applied in various ways. Output standards could take the simple form of quanta, e.g., absolute numbers of services delivered of a certain type and quality. They may also focus on improving the quality of the services delivered, rather than the quantum. Output standards can also take the form of, or include, principles. Some of the principles of the *Canada Health Act*, such as universality and accessibility, are an example of the use of principles as conditions.

Output standards may be focused at a broader levels, taking the form of outcomes, rather than output standards for specific services, by looking at broader measures of well-being or success of the population served.

4.3 Governance and Administration

As illustrated in Section 2.2, an equalization program may be governed and administered in a number of ways. Within an international framework, it would likely be desirable to have an independent body, perhaps, led by a board of ex-politicians and experts, with a qualified staff, something like the model of the Australian Commonwealth Grants Commission.

The Commission's mandate could include both policy and administrative matters. For example, it could extend to some or all of the following:

- The sectors to be equalized
- The allocation formula amongst recipient governments
- The financing formula amongst donor governments
- The aggregate level of funding
- Undertaking and publishing research and analysis
- Advising on the provision of data and statistics
- Assessing and making recommendation on the availability and quality of statistics
- Conducting and reporting on consultations
- Determining the levels of entitlements and support
- Administration of funding and financing
- Reporting and retaining records
- Overseeing and/or reporting on the adherence to conditions
- Overseeing periodic reviews of the program

The commission's authority could range from purely advisory to final decision-making, with possibilities in between. Its authority might vary depending on the nature of the matter in question. For example, its role might be advisory for sectors to be equalized and the aggregate level of funding, but final in the case of the allocation formulae. Or its decision-

making powers over the allocation formula might be subject to approval by a certain number of governments representing a certain proportion of the population of donor countries.

Alternatively, its decisions on allocation could stand, unless challenged by a certain number of countries with a certain percentage of the population.

4.4 Monitoring, Accountability, and Sanctions

Rather than having conditions and standards imposed, overseen, and enforced externally, one possible approach to administering and enforcing conditions is to require that they be included within legislation, regulations, or program criteria within each country. This is the approach followed in the European Union, as members states are required to pass a wide range of legislation in order to attain and maintain membership. If this were required of all nations, not just those receiving equalization, then the concern of discriminatory treatment of the latter group of nations would not arise.

Each nation would then have to report on its performance, in terms of meeting the conditions and outcomes, both to its own population and to the group of other nations. This approach would rely to a great extent on self-regulation and internal accountability to the population of the recipient nations. Under this arrangement, international oversight could involve periodic and selective external assessment and, perhaps, investigation in response to complaints.

It is important that the standards sets and outcomes expected be commensurate with the level of funding provided, or else failure is likely to result. This is one of the reasons that funding levels are seldom based on output or outcome measures. Outcomes cannot be guaranteed. Thus, funding based on achieving specific outcomes would result in a situation where recipient governments' policies and efficiency could drive funding levels with possibly perverse results. Additionally, it could potentially obscure the accountability of the recipient governments for their actions and

performance.

The difficulty of imposing sanctions in the case of violation of conditions is that it could harm the very people that the program is designed to help. However, reductions or even the elimination of full benefits in very extreme cases, such as use of funds for other purposes or fraud, would have to remain in the arsenal of sanctions.

5. FUNDING AND FINANCING

This section presents a brief discussion of possible models that might be used for an IEP, at least in the early years.

5.1 A General Model

As noted, the general model of equalization is "Expenditure Need less Revenue Means", but as indicated in Section 2.2, there is no limit to the variations in which this basic framework is applied in practice.

5.2 Expenditure Need

As noted in Section 2.2, expenditure need is and can be measured in a wide variety of ways. A general framework for measuring expenditure need that is often adopted is the product of Cost and Demand factors. These can be measured at several levels.

For example, cost could be an aggregate measure of service costs per person or per client. At a more disaggregated level, Demand can be specified as the product of Service or Workload requirements for various services, and Client group, adjusted for relative needs. Workloads, which are a measure of output, can be further expanded by identifying Input requirements to meet the workloads.

The costs or prices used would correspond with the level of detail in the formula. They may be subject to adjustment for relative differences within the nations. Also, it is essential, for comparability, that all prices and costs be converted to a common basis, by adjusting by Purchasing Power Parity indexes, rather than exchange rates.

Standards are often used for establishing the levels for the various components in the measurement of expenditure need. For example, standards could be used with respect to demand factors, such as the eligible client groups, the services to be provided and their levels and quality, the quantity and/or quality of inputs, and cost or price levels.

To illustrate some of the conceptual issues that may arise in establishing standards, consider the question of the choice of the eligible client group for primary and secondary education. Should it be based on age groups or enrolment? The general practice, in theory, is to choose measures for expenditure need that cannot be used by the recipient governments to influence the level of the grant. From that perspective, age groups would be more appropriate. However, the use of enrolment has a number of important benefits. First, age groups would potentially exclude adults seeking to augment their education. Secondly, age groups would result in funding services that may not be provided. Thirdly, and perhaps most important, funding based on age would not provide an incentive to increase enrolment, while funding based on enrolment could. (It is interesting to note, in this regard, that there was a minority view of a commissioner of the Commonwealth Grants Commission (1993) in Australia, in its report on grant relatives, in favour of using age groups, rather than enrolment, for the purpose of measuring expenditure need for primary and secondary education.)

5.3 Revenue Capacity

Revenue capacity is also measured in a variety of ways, ranging from simple aggregates to highly dis-aggregated revenue sources, such as under the Representative Tax System used in the Canadian equalization program. Regardless of the approach employed, as in the case of expenditure need, it is important that the common measures be based on using PPP indices, rather than exchange rates, in converting to a common currency.

5.4 Data

One of the difficulties of applying an

equalization model across nations, as opposed to sub-national governments within nations, is the much greater variation in circumstances and expenditure and revenue policies that are likely to exist. Thus, time and effort would be required to develop common measures and the necessary data, particularly to enable the use of more precise measures of expenditure need and revenue capacity on a common basis.

There tends to be a symbiotic relationship over time between an equalization program and social and economic statistics. The desire for greater equity generally creates the demand for more extensive, reliable and timely statistics. Since funding is based on the availability of these statistics, it is likely to support the development of the necessary improvements. Conversely, the availability of improved statistics enables greater precision and equity to be achieved and often fuels demands for further improvements. Thus, improved equity and improved statistics tend to be mutually reinforcing.

One of the important roles of an independent commission could be to advise, encourage and oversee the development of improved statistics along with other interested intergovernmental organizations, such as the United Nations, The World Bank, and the IMF.

5.5 Funding Among Recipient Nations: A Simple Model

Given these statistical difficulties, one simple model that could be applied, at least initially, for either a broad-based or sectoral equalization program is the following.

Expenditure needs would be set at a certain level per capita or per client, depending on the sector or sub-sector. The level could, for example, be set at some percentage of the level of expenditure per capita or per client in a group of the wealthier countries. Alternatively, the level could be set at that required to deliver a certain objectively set standard of service

Revenue capacity would be set at a

percentage of GDP that it would be reasonable to expect should be allocated towards the covered services. Perhaps, the revenue percentage would not be fixed but rise with the level of GDP per capita. All measures should be based on Purchasing Power Parity, to provide for comparability of purchasing power among the nations. The advantage of this approach is that it is relatively simple and provides some degree of rough justice until improvements in statistics and measures can be gradually implemented.

In this simple model, it is assumed that the aggregate budget would be set in advance, rather than allowed to emerge from the measurement of expenditure need and revenue capacity. The allocation of the budgeted funding level among the recipient nations, based upon their relative fiscal gaps, would then need to be determined. One simple approach would be to reduce the amounts on an equal basis per capita (adjusted both for need and PPP), in order to maintain a common equalization standard.

One controversial aspect of the design of an equalization program relates to the issue of a "fiscal incentive". This matter is also referred to as the "tax back" issue or as "risk sharing". As described above, measured revenue capacity would be fully included in determining funding levels. Thus, any improvement in a recipient government's fiscal capacity would be fully offset by a reduction in its grant. Some argue that this is the way an equalization program is supposed to operate - as a fiscal gap filling program. Other are concerned that there is no incentive for recipient governments to improve their fiscal capacity, because the increase in fiscal capacity is fully taxed back - the equivalent of a welfare trap. An alternatively way of looking at this structure is that full inclusion of revenue capacity implies that the donor governments bears all the risk of improvements or deterioration in a recipient government's revenue capacity. One approach to addressing this concern is to include less than 100% of revenue capacity in the funding formula, either in aggregate or at the margin.

5.6 Financing Among Donor Nations

How might financing be allocated among donor nations? And perhaps, more importantly, which nations should contribute to financing an IEP - only those nations that do not receive grants (a so-called "net" program) or all nations (a so-called "gross" program.).

While the net program is more highly redistributive, a Gross program offers a number of potential advantages. First, a Net program would likely be financed by only a limited number of countries, depending on the standards chosen. This could make the program quite politically fragile and inherently divisive. By comparison, a Gross program could contribute to greater political cohesiveness, since, in theory, at least, it would simulate the financing from a higher level authority by contributions by all member nations. Additionally, since recipient nations would be contributing, they would have to be concerned about the level of funding from a financing perspective, as well as a receiving perspective. They would also tend to be concerned about the meeting of conditions in the recipient nations. A fixed budget constraint for the program would also reinforce the effect of making recipient nation "A" concerned about the meeting of conditions

by other recipient nations, since any poorly used funds in another nation "B" would be at the expense of funding to nation "A".

The contribution rates could be based simply on a percentage of GDP, but it would be more equitable for the percentages to increase progressively with the level of GDP per capita.

6. CONCLUSIONS AND FURTHER WORK

It was argued in this paper that an international equalization program (IEPA) could constitute an additional effective form of development aid, that it could play an integrative role for a variety of current forms of international support, and that it could contribute to freer trade and closer political cohesiveness among nations. However, it was also pointed out

that there would likely be many counter arguments that would need to be adequately addressed and barriers that would need to be overcome for an IEP to be realized, even in a modest form.

Much more discussion and work would be required to be undertaken, along several lines, before such a program, even in a limited form, could be given serious consideration and implemented.

6.1 Political

First and foremost, there would need to be discussion both within and among the nations as to whether they could support such a program. The major donor nations would be concerned about the cost and the potential benefits, both absolutely and relative to other forms of aid. The recipient nations would also be concerned about such matters as the relative effectiveness of an equalization program and the nature of conditions that they would be willing to accept.

If there were sufficient interest, the issues could be explored through one or more conferences among politicians, government officials, agencies and NGOs involved in development, policy institutes, and/or academicians, etc.

6.2 Analytical

Analytical work would be required to examine the fiscal implications, for both donor and recipient nations, of alternative program designs, alternative measures for expenditure need and revenue capacity within those models, and alternative budget constraints. What would the aggregate cost be for funding, say, primary and secondary education, based on alternative standards? For a given cost, what are the trade-offs in benefits between, for example, financing a higher standard for education and little or no health services, as opposed to financing some health services but a lower standard for education? With regard to financing, what would the implications be of alternative distributions of financing among the nations?

It would require a fair bit of analytical work to answer these questions, even for the simple type of models outlined in Sections 5.5 and 5.6, and, of course, there are many variations on these models, as well as other models that could be considered.

6.3 A Pilot Project

Political support, the conferences and analytical work could culminate, in the first instance, in a relatively small pilot project for a sector or sub-sector.

What form might a pilot project take? The detailed design of a pilot project is beyond the intended scope of this paper and would benefit from input from other knowledgeable and interested parties.

However, some suggested characteristics would be:

- A single sub-sectoral program, with primary school education as a prime candidate
- A limited number of beneficiary countries (including perhaps a number with of unitary and federal governmental structures) meeting the specified criteria, including acceptance of the conditions
- A limited number of donor countries
- Funding sources could include;
- Existing and, perhaps, some additional funding from the beneficiary countries
- Reallocation of some existing funding from other governments or organizations, where possible
- Reallocation of some existing funding from the participating donor countries
- Additional funding from the participating donor countries

Several years of experience with a pilot project would provide a basis for assessing the key aspects of a wider program, such as monitoring and assessment processes, relative effectiveness of expenditures, accountability of recipient governments, the formulas for funding and financing, improvements in the quality and timeliness of data, consensus processes, and the

degree of political support based on the results.

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